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In the Supreme Court of the United States.

OCTOBER TERM, 1930

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

THOMPSON OIL & GAS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR RESPONDENT

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BRIEF FOR RESPONDENT

OPINIONS BELOW

The findings of fact and the opinion of the Board of Tax Appeals (R. 9–14) are reported in 15 B. T. A. 993. The opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 21–26) is reported in 40 Fed. (2d) 493.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 5, 1930 (R. 27). An order extending the time for filing a petition for certiorari ten days from the date of the order was signed by a Justice of this Court on July 3, 1930 (R. 29). Petition for a

writ of certiorari was filed July 11, 1930, and the writ was granted October 13, 1930 (R. 29). Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under Section 234 (a) (9) of the Revenue Act of 1918, in determining for any taxable year the capital value, recoverable through depletion allowances, of oil-mining properties acquired prior to March 1, 1913, there should be deducted from the March 1, 1913 value of the properties the amount of what the Treasury Department calls "sustained depletion" for earlier years, or the amount of "depletion" for earlier years that was *allowable*, under the Revenue Acts then in force, as deductions from gross income.

STATUTES AND REGULATIONS INVOLVED

These are set forth in an Appendix, pp. 43-77, below.

STATEMENT

This case involves the question of the proper "depletion" allowance, as a deduction from gross income in computing net income for 1918, to be taken by the respondent on account of exhaustion of capital invested in an oil mining lease.

The taxpayer (respondent) owned an oil mining lease which had been acquired prior to March 1, 1913 (R. 9). The value thereof on that date was $156,645.00 (R. 9, 10). In 1916 the taxpayer se-

cured an extension of its lease at a cost of $30,000 (R. 10). From March 1, 1913 to December 31, 1915, the taxpayer extracted 162,717 barrels of oil. Its deduction for "depletion" in computing net income under the Revenue Act of 1913 was computed, not by reference to the number of barrels extracted, or the value of the reserve at March 1, 1913, but by taking five per cent of the gross income from the sale of the oil. The depletion allowance for 1913–1915, computed by this method amounts to $6,322.02 —hereinafter referred to as "allowable depletion".

The Commissioner of Internal Revenue, in computing the taxpayer's income and profits taxes for 1918 prepared a "depletion schedule" wherein he determined as at March 1, 1913 a reserve of 278,000 barrels of oil and found that the extension in 1916 had added 300,000 barrels to the reserve.[1] Dividing the value by the number of barrels, he determined a "depletion unit". Multiplying the number of barrels, extracted between March 1, 1913 and December 31, 1915, by the "depletion unit" he determined what he calls "sustained depletion" for those years in the sum of $91,686.15 (R. 10). For 1916 and 1917 he found a new "depletion unit" computed by reducing the March 1, 1913 reserve by the number of barrels extracted to December 31, 1915 and increasing the balance by 300,000 barrels acquired in 1916; and reducing the March 1, 1913 value by "sustained deple-

[1] R. 10. These figures were not actually determined until after 1918, but were accepted by the taxpayer as accurate, and so stipulated at the trial. *It should not be assumed that they had been determined in 1913–1915.*

tion" for 1913–1915 and increasing it by $30,000, the cost of the new reserve (R. 10). By applying this unit to the number of barrels extracted in 1916 and 1917, he determined "sustained depletion" for those years.

The estimated oil reserve of March 1, 1913, increased for the extension of 1916, and reduced by the number of barrels of oil actually extracted from March 1, 1913 to December 1, 1917, is 36,627 barrels.[1] About this figure there is no dispute, and it represents the taxpayer's oil reserve at January 1, 1918. The capital recoverable at January 1, 1918, divided by this figure, will give the amount that should be allowed as depletion for each barrel extracted in 1918.

The basic question in this case is: What was the recoverable capital investment in the leasehold at January 1, 1918?

The Commissioner says that the recoverable capital investment at January 1, 1918 is the value at March 1, 1913 plus the cost of extension in 1916, minus "sustained depletion" for the period from March 1, 1913 to December 31, 1917.

The taxpayer claims that the recoverable capital investment in the leasehold at January 1, 1918 is what had been invested (the 1913 value plus the cost of the extension in 1916) reduced by "allowable" depletion for prior years—the amount of capital it had been permitted to recover, tax free, under the

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[1] For detail of figures see footnotes on p. 31.

Revenue Acts of 1913 and 1916. No difference has been claimed to exist between "sustained" and "allowable" depletion for 1916 and 1917,[1] so the dispute resolves itself into the question whether, in determining recoverable capital at January 1, 1918, the investment in the leasehold should be reduced by "sustained" depletion for 1913–1915, as contended by the Government, or by "allowable" depletion for those years, as claimed by the taxpayer.

The Board of Tax Appeals (six members dissenting) sustained the Commissioner (R. 11–17). The Circuit Court of Appeals for the Tenth Circuit, on the authority of *United States* v. *Ludey*,[2] reversed the Board (R. 21–26). This Court granted certiorari on October 13, 1930 (R. 29).

SUMMARY OF THE ARGUMENT

I. The question involved is purely one of statutory construction. The legislative intent of Congress should be sought in events prior to the enactment of the Revenue Act of 1918—the statutes and regulations in the light of which it was passed—and in contemporaneous departmental construction, rather than in subsequent events relied on by the Government.

Under the Corporation Excise Tax Act of 1909, Treasury regulations allowed depletion of oil wells to be deducted as part of "depreciation", the amount of depletion being determined by "reduction in flow" of wells. The regulations indicated the belief that by

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[1] See Government brief, footnote p. 4.

[2] 274 U. S. 295.

this plan the value would be extinguished coincident with the complete exhaustion of the property, and the thought was to permit the entire basic value to be recovered by deductions from gross income.

Under the Revenue Act of 1913, a deduction for depletion was provided but limited in each year to "not to exceed 5 percentum of the gross value at the mine of the output for the year". This limitation was probably regarded as merely a leveling provision to prevent too much variation between deductions from year to year. It was not expected to deprive taxpayers of the right eventually to recover their entire capital investments. This is shown by the language of Regulations 33, providing that no further deduction shall be made after the capital investment has been recovered.

It subsequently developed that the five per cent limitation did work hardship in certain cases, and the limitation was eliminated in the Revenue Act of 1916.

The Revenue Act of 1916 recognized the computation of depletion by reference to "reduction in flow" and specifically provided that when the aggregate allowances should equal the capital originally invested or the value at March 1, 1913, no further allowance should be made. This clearly indicated the expectation that the entire cost or March 1, 1913 value would eventually be recovered by depletion deductions.

The liberality of the 1916 Act, had it remained in force, would have offset the restriction in the 1913 Act. This was recognized by the Treasury Depart-

ment in Treasury Decision 2447 and Regulations 33 Revised. The latter, explaining the deduction for depletion, said:

"The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date."

This history constitutes the background of the Revenue Act of 1918.

II. The Revenue Act of 1918, providing for depletion on discovery values as well as on cost or 1913 value, was intended to be more liberal than the Revenue Act of 1916.

III. The Treasury Department, in close touch with the Revenue Act of 1918 while it was in Congress, published, the day after the bill became law, the preliminary edition of Regulations 45. Article 203 therein did not provide that the basic value of a lease should be adjusted for depletion "actually sustained whether legally allowable or not" but for "deductions for depletion which have or should have been taken to date". This contemporaneous departmental construction of the 1918 Act was exactly the construction the taxpayer now urges.

The permanent edition of Regulations 45, published as Treasury Decision 2831,[1] carried phrase-

[1] April 16, 1919.

ology similar to that in the preliminary edition. It was not until December 30, 1920[1] that the regulation took its present form.

IV. A. The deduction from gross income of depletion is in effect the subtraction from sale price of the cost of assets sold piecemeal.[2] Accordingly, it is not surprising to find that the Revenue Act of 1918 made similar provisions for determining the bases for computing gain or loss on sale and for computing depletion.

B. The 1920 edition of Regulations 45 contained parallel interpretations of the parallel sections of the Act.[3] These interpretations required adjustment to the basis in each case for depletion "*sustained*". If one of these interpretations was erroneous, the other must have been.

C. This Court found one of the parallel interpretations to have been erroneous.[2]

D. It follows that the other is equally erroneous. The Government's effort to distinguish *United States* v. *Ludey* on the ground that it involved a sale while we are here concerned with further exhaustion by depletion, fails in the light of the fact that in the *Ludey* case, at the instance of the Government, this Court held that depletion was in effect a series of sales.

V. The Government's position is inequitable. It would reduce the taxpayer's deductions for depletion

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[1] Treasury Decision 3107.
[2] *United States* v. *Ludey*, 274 U. S. 295.
[3] Articles 1561 and 203.

in years of actual operation and force it to take a loss of $85,364.13 after complete exhaustion of its wells—in a year when it would probably have no income against which the deduction for loss could be applied. The inequity of such treatment was conceded in the Government's brief in the *Ludey* case. The practice of the Bureau of Internal Revenue, in cases not involving adjustment for depletion in 1913–1915, is equitable and should be followed in this case. That procedure has been sustained by the Board of Tax Appeals and the courts.

VI. The departmental constructions relied on by the Government are not such as to be entitled to any weight in determining legislative intent. The provisions of Article 203 of Regulations 45 (1920 edition) were repudiated by the Revenue Acts of 1924, 1926 and 1928.

VII. Every argument here advanced on behalf of the Government was presented and necessarily rejected in *United States* v. *Ludey*.

The judgment of the Circuit Court of Appeals should be affirmed.

ARGUMENT

I

The legislative intent of the Revenue Act of 1918 should be sought in the statutes and regulations preceding its enactment, and in contemporaneous departmental construction, rather than in subsequent events

The question involved is purely one of statutory construction—the interpretation of that part of Sec-

tion 234 (a) (9) of the Revenue Act of 1918 which provides that in computing net income of a corporation there shall be allowed as deductions:

"In the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * * ."

In their effort to support the Treasury Department's position in this case, counsel for the Government claim to find evidence of the legislative intent of Congress in the subsequently promulgated provisions of Article 203 of Regulations 45 (1920 edition) and similar provisions of still later regulations, and in the Revenue Acts subsequent to that of 1918.

It is submitted that the legislative intent of Congress in passing a statute that was considered in 1918 and enacted on February 24, 1919, should be sought in events prior to the enactment—the statutes and regulations in the light of which the 1918 law was passed—and to contemporaneous departmental construction, rather than in subsequent events.

Accordingly, we present a brief history of the treatment of depletion allowances in the Revenue Acts and departmental regulations which form the background of the Revenue Act of 1918.

HISTORY OF THE STATUTES AND REGULATIONS CONCERNING DEPLETION

(a) Under the Corporation Excise Tax Act of 1909

The Corporation Excise Tax Act of 1909 provided for the deduction, in computing net income, of "a reasonable allowance for depreciation of property, if any",[1] but was silent as to whether this included an allowance for depletion of natural resources or whether any separate allowance for depletion was permissible.

Article 4 of Regulations 31,[2] promulgated under this act on December 3, 1909, provided:

"*Depreciation.*—The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the property, its cost value, and its use. * * * ."

The use of the word "exhaustion" indicates that the Treasury Department contemplated depletion of natural resources as being included under "depreciation".[3]

[1] Section 38, Second [3] (second). Appendix, p. 49.

[2] Appendix, p. 49.

[3] cf. *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, 369.

Treasury Decision 1606,[1] approved March 29, 1910, elaborated on Regulations 31 and covered specifically a number of points not dealt with therein. It is interesting to note that it contemplated the estimation of "depreciation" in oil and gas wells, as well as in buildings, machinery, etc., by the process of inventorying and valuing them at the beginning and end of the year. Under this process, depletion actually sustained was deducted from gross income unless offset by increment. It should be borne in mind that it was not until January 15, 1917 that this Court decided[2] that the word "depreciation" in the Act of 1909 did not include depletion of natural resources—the Court had specifically refused to pass upon the question in the earlier case of *Stratton's Independence* v. *Howbert*.[3]

It appears that when Treasury Decision 1606 was promulgated, the Department did not regard depreciation and depletion as deductible because representing a return of capital, but because representing loss in value of assets—a theory later abandoned. The method of computing the deduction was not based on original cost and probable life, or proportionate consumption of the asset, but upon the difference between market value at the beginning and at the end of the year.

Treasury Decision 1675,[4] approved February 11,

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[1] 13 Treasury Decisions 39. See Appendix, p. 50.
[2] *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503.
[3] 231 U. S. 399.
[4] 14 Treasury Decisions 16. Appendix, p. 51.

1911, revised Treasury Decision 1606. It covered, in paragraphs 80 ff., depreciation (in which term it included depletion of natural resources) alike in the cases of mining and of oil producing corporations, and provided for a deduction from gross income for exhaustion of natural deposits and depreciation and obsolescence of improvements, on the basis of the original capital investment. A further deduction was allowed for the unearned increment in value of natural deposits, through the process of excluding a proper proportion from gross income. (Pars. 82–84.) The method was by appraisal of the deposit *en bloc* and its reduction to a unit value—per ton, barrel, etc. Here for the first time the idea of basing the deduction upon the cost (adjusted for increment to the effective date of the law) was proposed.

Since the oil companies had never made a practice of calculating the total oil content or "ultimate production" of their deposits, the method prescribed was impracticable if not impossible of application. In consequence, conferences were held between representatives of the leading oil companies and of the Treasury Department, resulting in the promulgation of Treasury Decision 1755[1] on January 22, 1912, amending Treasury Decision 1675. This Treasury Decision made new regulations to "govern the rate of return of capital invested on the basis of the rate of depletion of oil producing properties," recognizing that the depletion deduction was for the purpose of

[1] 15 Treasury Decisions 12. Appendix, p. 55.

accomplishing a *"return of capital"*. The method of computation adopted was that which had been in practice by the leading oil producing companies for many years. It is known as the "reduction in flow" method, the deduction being computed by comparing the number of barrels produced from a given well over similar periods at the beginning and at the end of the year. Under this method, it was not necessary to estimate the total amount of oil expected to be produced from a well, the only factors essential to the computation being (1) the cost of the well, (2) the rate of flow at the beginning of the year, and (3) the rate of flow at the end of the year.[1] The regulation carried a footnote reading:

"It will be apparent that by the plan suggested the value of the producing property appearing in the capital assets of the company will be automatically and wholly extinguished, coincident with the complete exhaustion of the product, with the exception of such salvage as may remain after said exhaustion."

The scheme was to permit the ultimate recovery, free of taxation, of the entire cost of the property, distributed not according to the number of barrels of oil extracted in each year but according to the comparative rates of flow from year to year. The reduction in flow did not necessarily bear any ratio to the amount of oil produced.

In *Stratton's Independence* v. *Howbert*,[2] the taxpayer claimed as a deduction for depreciation the

[1] The method of computation, should the Court be interested, is explained in T. D. 2447, Appendix, p. 62.

[2] 231 U. S. 399.

entire difference between the proportionate cost of iron ore in the ground and its sale price after extraction. This Court held on December 1, 1913, that the entire difference was not deductible, and found the record insufficient as a basis for allowing any lesser deduction, although it recognized in passing "that the revenues derived from the working of mines result to some extent in the exhaustion of capital". It was not until 1917 that this Court held that "depreciation" under the Act of 1909 did not include depletion of minerals.[1]

In the meantime, Congress, in the light of the Treasury regulations which permitted deductions for depletion of oil, computed by the "reduction in flow" method, enacted the Revenue Acts of 1913 and 1916.

(b) Under the Revenue Act of 1913

The Revenue Act of 1913 restricted deduction for depreciation to the loss attributable to use, wear and tear of property, but made a separate provision for depletion of mines, including oil wells by the phrase: "all other natural deposits". The depletion deduction was limited[2] to "not to exceed 5 percentum of the gross value at the mine of the output for the year for which the computation is made". It subsequently appeared that this 5 per cent limitation might work very harshly but at the time it was probably regarded as merely a leveling provision to prevent too much

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[1] *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503.

[2] Section 2 G (b) (second), Appendix p. 58.

variation between deductions from year to year. The fact that it was not expected really to deprive taxpayers of the right to recover their entire capital investments by a series of deductions is shown by the provisions in Article 142 of Regulations 33:

"If the rate of 5 per cent per annum shall return to the corporation its capital investment prior to the exhaustion of the deposits, the rate on which the annual deduction for depletion of deposits is based must be lowered in accordance with the estimated number of years it will take to exhaust the estimated reserves.

"In case the reserves shall be in excess of the estimates, no further deduction on account of depletion shall be made where the capital investment has been returned to the corporation."

TheseR egulations 33,[1] which interpreted the Revenue Act of 1913, made no distinction in the treatment of mines and of oil and gas wells. But there was nothing in them inconsistent with the existing practice under Treasury Decision 1755, except where the 5 per cent limitation might impose a maximum limit upon the deduction. Treasury Decision 1755 was continued in force, and producers of oil took their depletion deductions accordingly. On February 21, 1916, this Court decided *Stanton* v. *Baltic Mining Co.*[2] In that case the taxpayer had claimed that the five per cent limitation would prevent it from recovering the entire cost of its property and urged that this rendered the

[1] Appendix, p. 59.
[2] 240 U. S. 103.

Act unconstitutional. This Court upheld the validity of the statute.

The possible injustice of the five percent limitation was thus called to the attention of Congress, which, in the Revenue Act of 1916, abolished that limitation.

(c) Under the Revenue Act of 1916

By the time the Revenue Act of 1916 was under consideration, the question passed on in *Von Baumbach* v. *Sargent Land Company*[1] had been raised in the lower courts, and Congress avoided any ambiguity in the word "depreciation" by eliminating it and providing for "exhaustion"[2] not only by wear and tear but by depletion; providing "in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow but by settled production or regular flow",[3] with the restriction that when the allowances so authorized should equal the cost or March 1, 1913 value, no further allowance should be made. By this, the statute very obviously adopted the method provided in Treasury Decision 1755 for computing depletion by reference to "reduction in flow", and also clearly expected that the deductions would eventually equal the cost or March 1, 1913 value of the property.

If the Revenue Act of 1916 had continued in force, a taxpayer, by computing depletion according to

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[1] 242 U. S. 503, holding that the word "depreciation" in the Act of 1909 did not include depletion of minerals.

[2] Which was broad enough to cover depletion. cf. *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, 369.

[3] Sec. 12 (a) (second). See Appendix, p. 61.

"reduction in flow" would ordinarily have been able, before final exhaustion of his oil reserve, to have recovered, tax free, his entire capital investment (or 1913 value), and only by reason of the statutory limitation on aggregate deductions, would be prevented from recovering even more. The liberality of the 1916 Act, had it remained in force, would have offset the restriction in the 1913 law.

Following the passage of the Revenue Act of 1916 came Treasury Decision 2447,[1] emphasizing the necessity of computing depletion under the "reduction in flow" method, but once more recognizing the legislative intent to allow the entire capital investment at 1913 to be recovered, in the following language:

"The provision of the law authorizing the depletion deduction, designed as it is to provide a means whereby the invested capital of an individual or corporation may not be subject to the tax imposed by this title, * * * [2] * * *. By capital invested, as herein used, is meant the fair market value of the properties as of March 1, 1913, if acquired prior to that date, or their actual cost if acquired subsequent to that date, as it relates to the owner in fee of the properties."

In Regulations 33 Revised,[3] the Treasury Department began to try to get away from the "reduction in flow" method of computing depletion and pro-

[1] February 8, 1917, 19 Treasury Decisions 31, see Appendix, p. 62.

[2] That part of this Treasury Decision which denied depletion deductions to lessees was overruled in *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364.

[3] Approved January 2, 1918. Appendix, p. 70.

vided for an alternative method (although not authorized by the statute) where a reasonable estimate of probable resources seemed possible.[1] These regulations also stressed the statutory provision that after the aggregate allowances equalled the investment or 1913 value no further allowances should be made,[2] going on to say:

"The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date."

So it is observed that the Treasury Department, up to 1918 in any event, consistently recognized that it was the intent of Congress to permit a taxpayer, through deductions for depletion, to recover tax free the full amount of his investment, or the value at March 1, 1913 of his property, but no more.

This constitutes the background of the Revenue Act of 1918—the departmental interpretation in the light of which that Act was passed. And it is to that background, and to departmental construction contemporaneous with the enactment, that one should look in determining the Congressional intent, rather than to subsequent regulations inconsistent therewith.

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[1] Art. 170, Appendix, p. 71-2.
[2] Art. 170, Second Paragraph, Appendix, p. 70.

II

The legislative intent of the Revenue Act of 1918 is indicated by the fact that its provisions with respect to depletion allowances were more liberal than the prior statutes

In the Revenue Act of 1918, Congress abandoned the provision *requiring* depletion of oil wells to be computed according to "reduction in flow" and left the question of the *method* of computation open for decision by the Department or the Courts. But it became even more liberal than in the Revenue Act of 1916, and provided[1] for depletion on the basis of "discovery value" in cases of exploration subsequent to March 1, 1913—permitting taxpayers, in such cases, to exclude from taxable income an aggregate in excess of the amount of their actual investment.

Certainly this liberality negatives any presumption of a legislative intent in the 1918 Act to be *less* liberal than under the Act of 1916. Similarly, the even more liberal provisions of the Revenue Acts of 1926[2] and 1928,[3] allowing depletion deductions by reference to percentages of gross income from the property, with a *minimum* based upon cost or 1913 value, can hardly be interpreted as legislative constructions of the 1918 Act rendering it less liberal than that of 1916.

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[1] § 234 (a) (9). Appendix, p. 43.
[2] § 204 (c) (2).
[3] § 114 (b) (3).

III

The contemporaneous construction of the Revenue Act of 1918 by the Treasury Department sustains the taxpayer's position

The Revenue Act of 1918 was considered by Congress for many months and finally enacted on February 24, 1919. That the Treasury Department was in close touch with the form of the bill and undoubtedly had much to say about its phraseology, can hardly be doubted. It is certain, however, that on the day after the bill became law, the Treasury released the preliminary edition of Regulations 45. Article 203[1] did not provide that the basic value of a lease should be reduced by depletion actually sustained whether legally allowable or not, *but for "deductions for depletion which have or should have been taken to date."* By this it clearly appears that the Treasury believed that the adjustment should be for the amounts which were properly deductible under the prior Revenue Acts. The reasonableness of this construction is demonstrated by the fact that it was carried directly into the statute in the Revenue Acts of 1924, 1926 and 1928.[2]

The preliminary edition was revised and enlarged by Treasury Decision 2831[3] under date of April 16, 1919, which was published as the permanent edition (1919) of Regulations 45.[4] In this revised edition, Article 203 provided for the adjustment of the basis

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[1] Appendix, p. 45.
[2] See pp. 39-40, below.
[3] 21 Treasury Decisions 170.
[4] Appendix, p. 45.

for "deductions for depletion which *has* or should have been taken to date," the only change from the preliminary edition being to substitute "has" for "have". This Treasury Decision, which, if a proper construction of the statute, had the force and effect of law, remained unchanged until December 30, 1920, when it was amended by Treasury Decision 3107,[1] where the regulations took the form in which they are now relied upon by the Government.[2]

IV

The decision in United States v. Ludey is controlling in the present case

A. THE PARALLEL BETWEEN PROVISIONS FOR COMPUTATION OF GAIN OR LOSS AND FOR DEPLETION ALLOWANCES

As shown above, the thought underlying the statutory provisions for depletion deductions was to avoid the inequity of taxing as income the capital value existing at March 1, 1913, or the capital invested after that date. It was similar to the thought that upon the sale of property, not the entire receipts, but only the *gain*—the difference between sale price and cost (or 1913 value) should be treated as income.[3] The two thoughts are necessarily parallel, for in final analysis, the deduction of "depreciation" or "depletion" is in effect the subtraction from sale price of the cost of assets sold piecemeal.[4]

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[1] 22 Treasury Decisions 556.
[2] Appendix, p. 48.
[3] cf. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179.
[4] *United States* v. *Ludey*, 274 U. S. 295, discussed in detail below.

Accordingly, it is not surprising to find that the Revenue Act of 1918 made similar provisions for determining the base for computing gain or loss on sale, and the base for computing depletion. Section 202 (a) provided:

"That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

"(2) In the case of property acquired on or after that date, the cost thereof * * *."

Section 214 (a) (10) (applying to individuals) and Section ~~230~~ 234 (a) (9) (corporations) provided for the deduction in computing net income of:

"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * *."

The theory of reducing sale price by cost to determine taxable gain probably seemed too obvious to require elucidation in the regulations, but with respect to depletion the Treasury Department con-

tinued the explanation that had appeared in earlier regulations, saying in Article 201 of Regulations 45:[1]

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions (see article 222), but not including land values for purposes other than the extraction of minerals."

"The limitations prescribed" refer to cost, the value at March 1, 1913, or the value within thirty days after discovery, indicated in Section 214 (a) (10) which is printed in Regulations 45 immediately before Article 201. There are no other "limitations" prescribed in that section nor in the Act.

It is submitted that this is a fair construction of the statute, and that Article 203 of Regulations 45, as subsequently amended on December 30, 1920, is inconsistent therewith, and an erroneous interpretation of the Act.

A striking example of the casuistry of the Government's argument appears on pp. 21–22 of its brief. After repeating that part of Article 201 quoted above, the brief continues:

"The capital value which Article 201 contemplates being returned to the taxpayer by annual depletion

[1] 1920 edition. The phraseology of the preliminary edition (Feb. 25, 1919) and the regular 1919 edition (April 16, 1919) was slightly different, but the substance was the same. See Appendix, p. 44-46.

and depreciation deductions is, quite clearly, we think, the *capital remaining when the 1918 Act became effective.*"

But the Government did not complete the quotation of Article 201, which also provided:

"When used in these articles of the regulations covering depletion and depreciation—

"(a) The term 'basic date' indicates the date of valuation, i.e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery, or within 30 days thereafter, in the case of discovery."

B. THE PARALLEL REGULATIONS INTERPRETING THE PARALLEL STATUTORY PROVISIONS

The 1920 edition of Regulations 45[1] contained two parallel interpretations of the parallel sections of the Act, quoted above. They dealt with adjustments to be made to the basis for determining gain or loss and to the basis for determining depletion, respectively. They were consistent with each other, as were the statutory provisions they interpreted, and if one of them was erroneous, so, necessarily, was the other.

Article 1561 provided:

"For the purpose of ascertaining the gain or loss from the sale * * * the basis is (a) its fair market price or value as of March 1, 1913, if acquired prior

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[1] Published January 28, 1921, but embodying the change effected in Art. 203 by Treasury Decision 3107 on December 30, 1920.

thereto, or, (b), if acquired on or after that date its cost or its approved inventory value. *In both cases proper adjustment must be made for any depreciation or depletion SUSTAINED.*" (Emphasis supplied)

The pertinent part of Article 203 reads:

"(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but *minus (3) depletion and depreciation SUSTAINED*, whether legally allowable or not, from the basic date to the taxable year * * *." (Emphasis supplied)

C. TREATMENT BY THIS COURT OF ONE SIDE OF THE PARALLEL

The intent of the statute (Section 202 (a)) and the propriety of the regulation (Art. 1561), covering gain or loss on sale, were considered by this Court in *United States* v. *Ludey*.[1]

Ludey had sold an oil well. In computing his gain he had taken the difference between cost and sale price, without any adjustment to cost for depreciation or depletion occurring during his ownership. The Treasury Department, relying on Article 1561 (1920 edition) and on *Appeal of Even Realty Company*,[2] contended that as he had operated the well and sold the oil produced, he had been recovering, in the sale price of each barrel, a part of the cost of his investment in machinery, development ex-

[1] 274 U. S. 295.
[2] 1 B. T. A. 355, 359.

pense, and oil underground; and that having thus recovered it (exempt from tax to the extent of the allowable deductions for depreciation and depletion) he should not be permitted to recover it over again upon the sale of the well. This argument was upheld by the Court which said with respect to the depreciation:[1]

"The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold."

and:[2]

"When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets."

That the same is equally true of a capital asset consisting of natural resources, or a leasehold interest, is obvious. And this Court specifically so held saying:

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[1] 274 U. S. at pp. 300-1.
[2] id., p. 301.

"The reasons urged for refusing to apply the rule specifically to oil mining properties seem to us unsound."

And later:[1]

"The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks."

Citing *Lynch* v. *Alworth Stephens Co.*, the court added:

"In essence the deduction for depletion does not differ from the deductions for depreciation."

Thus, *at the instance of the Government*, this Court settled beyond peradventure the proposition that when a taxpayer exhausts the oil from a well, *he is selling his capital piecemeal, and recovering his cost tax free, ratably as he sells it.* It is obvious that, the statutory provisions as to the basis being similar, the same adjustments should be made to the common basis, whether the sale be in one parcel or piecemeal. It would be wholly illogical to say that if the sale is in one parcel, the capital to be recovered is one amount, but if it be piecemeal a different amount should be recovered.

This brings us to the question of the correct amount by which the basis should be adjusted.

The Treasury Department urged that the words "proper adjustment must be made for any deprecia-

[1] 274 U. S. at p. 303.

tion sustained" in Article 1561 meant something different from making adjustment for depreciation and depletion allowable as deductions under the earlier Revenue Acts. Although the Revenue Act of 1913 had been enacted in the light of regulations providing for computing depletion by reference to "reduction in flow" and had been enforced by the application of the same and similar regulations, with the five per cent limitation added, the Department claimed that the depletion "sustained" was something different.[1] The effect of the Treasury's proposition is to require adjustment of cost (or 1913 value) for items of depletion attributed to 1913, 1914 and 1915, which items were not deductible under the Revenue Act of 1913; *the very method of ascertaining them having been unrecognized while that Act was in force.*

Having satisfied the Court in the *Ludey* case that, upon the sale of his oil well, the taxpayer should make adjustment to cost for depletion which had occurred during his operation, the Government addressed itself to the *quantum* of that deduction. It urged that the cost should be adjusted for depletion during the taxpayer's operation, including "sustained depletion" for 1913, 1914 and 1915, rather than for the depletion which the taxpayer had been permitted to recover, tax free, during those years.

[1] The cost or March 1, 1913 value of the well is divided by the estimated quantity of oil in reserve at acquisition or March 1, 1913, giving a unit cost to each barrel of oil in the ground. This unit cost is multiplied by the number of barrels extracted in each year to find "sustained" depletion.

But it recognized the weakness of its claim, and asked, in the alternative, for an adjustment in the amount of the depletion *allowable* under the Revenue Act of 1913 for those years.

The Court adopted this alternative, saying:[1]

"We cannot accept the Government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. **Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years.**"

D. PROPER TREATMENT OF THE OTHER SIDE OF THE PARALLEL

The statutory definitions of the bases for computing gain or loss and for computing depletion being the same, and Articles 1561 and 203 of Regulations 45 (1920 edition) making similar provisions for adjustment to these bases for depletion, the same treatment should be accorded to both articles. This Court held, in effect, that Article 1561 must be modified to provide for adjustment for *allowable* instead of "*sustained*" depletion. Article 203 should be similarly modified.

The Government now urges[2] that the present case differs from *United States* v. *Ludey* in that there the question was with respect to gain or loss upon a *sale*, while here we are dealing with depletion deductions during continued operation. But it should be borne

[1] 274 U. S. at p. 304.

[2] Brief, p. 16.

in mind that this Court, in the same *Ludey* case, upheld the Government's contention that the reason for making the adjustment to cost was that in operating the well and claiming depletion, the taxpayer was *selling* his capital piecemeal. If *past* depletion is a series of sales of parts of invested capital, *future* depletion is equally a series of similar sales. The basis for computing recoverable capital should be the same whether the asset is sold in one parcel, in ten, or in a thousand.

V

The inequity of the Government's position

According to the stipulated figures, the taxpayer had on hand at January 1, 1918 an estimated reserve of 326,627 barrels[1] of oil. The 1913 value of $156,645[2] increased by $30,000 cost of addition in 1916, and adjusted for depletion *allowable*[3] for the years 1913–1917 was $160,050.90.

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[1] Findings, R. 10:

Estimated oil reserve 3/1/13		278,000 bbl.
Added 1916		300,000
		578,000
Production 1913–1915—162,717 bbl.		
1916	— 49,452	
1917	— 39,204	251,373
Balance of estimated reserve 1/1/18		326,627 bbl.

[2] Findings, R. 10.

[3] Depletion allowable under 5% limitation for 1913–1915 (see B.T.A. opinion, R. 11) $ 6,322.02

Sustained depletion 1916 (Findings, R. 10) 11,307.69*

" " 1917 " " " 8,964.39*

$26,594.10

* The taxpayer raised no question as to whether the allowable depletion for 1916 and 1917 differed from sustained depletion, and accepted the Department's figures for the adjustment to be made for those years. cf. footnote p. 4 of Government's brief.

The taxpayer claims that subsequent depletion deductions should be computed upon this base.

The Treasury Department says that adjustment should be for "sustained" depletion of $111,958.23[1] instead of allowable depletion of $26,594.10, leaving $74,686.77[2] at January 1, 1918 to be recovered by subsequent depletion deductions, and a difference of $85,364.13[3] to be recovered, under the *Ludey* decision, when the taxpayer eventually sells the property or abandons operation of the wells. It will pay higher taxes during operation, and have a large loss to claim in the year of abandonment, when it will probably have no income against which the deduction for loss can be applied. The inequity of such

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[1] Findings R. 10

"Sustained" depletion 1913–1915	$ 91,686.15
" " 1916	11,307.69
" " 1917	8,964.39
	$111,958.23

[2] Findings R. 10

March 1, 1913 value	$156,645.00
Additions at cost, 1916	30,000.00
	186,645.00
"Sustained" depletion 1913–1917	111,958.23
	$ 74,686.77

[3] Balance of capital at 1/1/18 not recovered by depletion allowances (of this the taxpayer claims all is recoverable through subsequent depletion allowances) $160,050.90
Treasury says recovery limited to 74,686.77

Difference, to be recovered at eventual sale or abandonment $ 85,364.13

Note that this is the same as the difference between "sustained" depletion 1913–1915 $ 91,686.15
and "allowable" depletion 1913–1915 6,322.02
$ 85,364.13

treatment was conceded in the Government's brief in the *Ludey* case[1] in the following statement:

"indeed it is more equitable and just that the taxpayer should be allowed to replace his capital as it is expended than to require him to wait until the capital asset has entirely disappeared before any recoupment is allowed."

The practice of the Bureau of Internal Revenue with respect to fixing rates for depreciation and depletion, in cases not involving adjustment for depletion in 1913–1915, is well settled. At acquisition the life of a machine or building, or the recoverable content of a mine or oil well, is estimated as accurately as possible. Allowances for exhaustion are based upon this estimate. If, subsequently, the estimate is proven erroneous, a new estimate is made, and the unrecovered cost is spread over the balance of the life of the property. The Bureau refuses to go back and readjust the taxes for prior years in the light of subsequent events.

Thus if a mine cost $10,000 and is estimated to contain 100,000 tons of recoverable coal, the Commissioner will allow depletion at ten cents a ton. If after 50,000 tons of coal have been recovered and $5,000 deducted for depletion, it is discovered that there are really only 25,000 tons left, he will allow the balance of cost, $5,000, to be spread over the balance of coal, 25,000 tons, and allow depletion at twenty cents a ton. If the new estimate should

[1] Point III, p. 21.

show that the original one was low, and that there are still 100,000 tons of coal recoverable, the depletion rate would be reduced to five cents a ton.[1]

In this the Commissioner has been sustained by the Board of Tax Appeals[2] and the Courts.[3]

In the *Kehota Mining Company* case the District Court said:

"The taxpayer is entitled to recover, by way of depletion, the cost of his property. A part of this cost has already been allowed to him in a computation based on the estimated quantity of mineral products in the property. On the making of a new or corrected estimate, thereafter the annual depletion allowance will be computed on the basis of the new estimate, and allowed to the taxpayer, until the entire cost of the property has been recovered by way of depletion allowances. There can be no misunderstanding of the language of the regulation. The new estimate is only to be used in determining the allowances to be distributed annually to the *capital remaining to be recovered.*"

The Circuit Court of Appeals affirmed without discussion, referring to the opinion below. And this Court refused certiorari.

The taxpayer is entitled to spread the cost of his property over the number of units to be extracted. If he correctly estimates the quantity but fails, of his own negligence, to take deductions for allowable

[1] A.R.R. 431, 5 C.B. p. 193.

[2] *Stouts Mountain Coal Co.*, 4 B.T.A. 1292; *Sterling Coal Co. Ltd.*, 8 B.T.A. 549; *Phila. Quartz Co.*, 13 B.T.A. 1146; *Staub Coal Co.*, 16 B.T.A. 584.

[3] *Kehota Mining Co.* v. *Lewellyn*, 28 Fed. (2d) 995, 30 Fed. (2d) 817, cert. denied 279 U. S. 864.

depletion, he cannot make up for his omission by taking additional deductions in subsequent years. But if he has made an honest mistake, he is allowed to spread the recoverable balance of his cost over the balance of the minerals to be extracted. He does not lose the right to recover his capital. In the *Ludey* case, this Court held that he did not lose the right to recover his capital by reason of the limitation in the 1913 Act but could get it back upon a sale of the property. That the same balance should be recoverable if the sale is in instalments is only just. And, under the *Kehota* case, the Board cases, and the Commissioner's own regulations, the proper way to recover the recoverable balance when the property is operated, rather than sold in one parcel, is by depletion—spreading the balance to be recovered over the remaining minerals to be extracted.

VI

The departmental interpretation relied on by the Government is not such as to be entitled to any weight as indicative of legislative intent

Of course it is true, as stated on page 12 of the Government's brief, that a departmental regulation will have the force and effect of law *"if not unreasonable or inconsistent with the statute."* This Court held in the *Ludey* case that Article 1561 of Regulation 45 was unreasonable, and we submit that the parallel provisions of Article 203 are equally unreasonable.

If the article should be considered, as the Government's brief claims on page 126—"not as an inter-

pretation of the law but as a supplement to it"—then it is submitted the Treasury Department is usurping legislative functions.

Contemporaneous departmental construction, if reasonable, is entitled to considerable weight as indicative of legislative intent. The Treasury Department was in contact with Congress during the many months that the Revenue Act of 1918 was under consideration. It was so well conversant with what was going on in Congress that it had Regulations 45 all ready to promulgate as soon as the statute might be passed. And the preliminary edition of Regulations 45 was published on February 25, 1919, before the Revenue Act was twenty-four hours old.

In that preliminary edition and in the revised and enlarged edition of Regulations 45, approved April 16, 1919,[1] the language of Article 203[2] was in no way ambiguous and clearly provided that the adjustment to cost or 1913 value for prior depletion should be for the depletion which *had or should have been taken to date.* This could only have meant the depletion which should have been taken in accordance with the laws in force for the years referred to. The use of the word "taken" indicates clearly that the intention was to require adjustment for depletion, computed by reference to prior statutes, which should have been deducted on tax returns—not some figures which might have been set up on books for the purpose of determining what the depletion allowance might

[1] T.D. 2381, 21 Treasury Decisions 170–222.

[2] See p. 21, supra; also Appendix, p. 45.

have been had the statutes been different. Only on December 30, 1920, after the contemporaneous departmental construction had continued for almost two years was this regulation altered to the form in which it is now relied upon by the Government.[1]

Of course departmental construction, long continued and generally acquiesced in, has very great weight in the interpretation of statutes. But in *Iselin* v. *United States*,[2] this Court held that an interpretation seven years old was not "long continued" and was not comparable to the forty-year old constructions in *National Lead Company* v. *United States*.[3] Although the regulation relied upon by the Government, was promulgated on December 30, 1920, we have been unable to discover any instance in which it was actually applied, in such a final determination as to render it litigable, prior to the determination in this very case (November 14, 1925). It is well known, among those who practice before the Treasury Department, that, when in 1919 the statute dropped the requirement that depletion be computed by "reduction in flow" and the Treasury Department began to insist that depletion could be computed in every case by reference to reserves of oil underground, which it claimed could be estimated by the study of production rates and pressures over a series of years, the first thing that was done was to prepare a form known as "Form O", on which tax-

[1] T.D. 3107, 22 Treasury Decisions 556–557.
[2] 270 U.S. 245, 251.
[3] 252 U.S. 140.

payers were required to return detailed information with respect to oil wells from the date of their discovery. The collection of data under Form O, the compilation of comparative statistics based upon such data, and the attempt to determine quantities of oil in the secret recesses of the earth took several years. As each new year's returns came in, the Department found it desirable to correct the computations for prior years in the light of the new information, and was not actually closing any substantial oil producers' cases for 1918 and subsequent years, until 1925. Consequently, taxpayers were not in a position to challenge the validity of Article 203 of Regulations 45 (1920 edition) in the courts, because the only processes by which the question could be litigated required, as a necessary preliminary, the determination or assessment of a tax by the Commissioner of Internal Revenue.

This taxpayer's 1918 tax was not finally determined by the Commissioner until November 14, 1925 and immediately (January 4, 1926) the taxpayer commenced this litigation.

When the courts have spoken of long continued departmental construction, they have meant departmental construction which had continued through many years during which it would have been possible to test its validity, judicially. In the instant case, the regulation, dated December 30, 1920, was applied to the taxpayer on November 14, 1925—less than five years later, during which period it seems that no one else had had a fair opportunity to test its validity.

The Government relies[1] on the proposition that Congress "has reenacted in each successive Revenue Act, in substantially the same language, the provision of the Revenue Act of 1918 herein involved" and relies on this as legislative approval of the regulations. The sections of the subsequent Revenue Acts cited by the Government, it is true, are like the section considered in the 1918 Act, in general terms providing for reasonable allowances but not indicating the base upon which they shall be computed or the method of computation. The Government overlooks, however, that in other sections of the Revenue Acts of 1924, 1926 and 1928, Congress specifically covers the question of what the base should be and how it should be adjusted. Section 204 (c) of the Revenue Act of 1924 provides:[2]

"The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property" [with exceptions not here pertinent].

Subdivision (b) thus referred to, provides:

"The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property * * * [exception not here pertinent] or (B) the fair market value of such property as of March 1, 1913, whichever is greater."

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[1] Brief, p. 13.

[2] Appendix, p. 75.

And Section 202 (a) of the same Act provides for the computation of gain or loss as being the difference between the basis provided in Section 204 and the amount realized.

But Section 202 (b) provides:

"In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property."

So, it is apparent that under the 1924 law, Congress intended the basis for depletion to be adjusted, not for "sustained depletion" of prior years, but for "allowed depletion."

The same is true of the Revenue Acts of 1926[1] and 1928,[2] except that instead of adjustment for depreciation "previously allowed," the adjustment is for depletion, etc., "which have since the acquisition of the property been *allowable* in respect of such property under this Act or prior income tax laws." If there was ever a case of legislative overruling of departmental constructions, it appears in the Revenue Acts of 1924, 1926 and 1928. And the continued repetition in Articles 203 of Regulations 65 and 69, and 222 of Regulations 74, of the require-

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[1] §§ 204 (c), 204 (b), and 202 (b). Appendix, p. 75-6.
[2] §§ 114 (b) (1), 113 (b), and 111 (b). Appendix, p. 76-7.

ment that the base be adjusted for "depletion and depreciation sustained whether legally allowable or not," is as nearly a direct defiance of the statutes as one could hope to find.

VII

Every argument advanced on behalf of the Government in this case was presented and necessarily rejected in United States v. Ludey

A comparison of the Government's brief in this case with that filed by it in *United States* v. *Ludey* shows the same arguments in both. In both the generality of the statutory provisions was stressed, and claim made that the Treasury Department had power, in effect, to legislate as to how the depletable base should be adjusted. In both the departmental regulations were said to have been ratified by re-enactment of the interpreted sections of the statute. In both we find the same argument with respect to the alleged necessity for adjustment of the basis by "sustained depletion" for 1913–1915 rather than by depletion "allowable" for those years in accordance with the revenue law then applicable. The Government's position in the *Ludey* case was rejected by this Court. The Court held that adjustment should be made only for "allowable" depletion for prior years. A similar ruling is sought by the taxpayer in this case.

CONCLUSION

The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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March 10, 1931

REVENUE ACT OF 1918 (approved February 24, 1919):

"SEC. 214. (a) That in computing net income [of individuals] there shall be allowed as deductions:

* * * * * * * *

"(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

"SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * *

"(9) [The language of this subdivision is identical with that of subdivision (10) of Sec. 214 (a), above]."

REGULATIONS 45 (1919 permanent edition) TREASURY DECISION 2831, (21 Treasury Decisions 170, 221, 222) approved April 16, 1919:

"ART. 201. Depletion of mines, oil and gas wells.—A reasonable deduction from gross income for the depletion of natural deposits and for the depreciation of improvements is permitted, based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or, (c) upon the fair market value within 30 days after the date of discovery in the case of mines, oil and gas wells discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. The essence of this provision is that the owner of such property, whether it be a leasehold or freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to the fair market value as of March 1, 1913, of the properties owned prior to that date, or an amount equal to the fair market value within 30 days after the date of discovery of mines, oil or gas wells discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost; plus in any case the subsequent cost of plant and equipment (less salvage value) and underground and overground development, which is not chargeable to current operating expense, but not including land values for purposes other than the extraction of minerals. Operating owners, lessors and lessees are

entitled to deduct an allowance for depletion, but a stockholder in a mining or oil or gas corporation is not. See further articles 839 and 844. [Articles 839 and 844 deal with invested capital]."

"ART. 203. Capital recoverable through depletion allowance in the case of lessee.—In the case of a lessee the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the leasehold, or its fair market value as of March 1, 1913, or its fair market value within 30 days after discovery, as the case may be, plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which *has* or should have been taken to date and (d) the portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion. Any annual or periodical rents or royalties supplementing the bonus or other amount paid for the lease may be charged to current operating expenses or, *until the property reaches the operating stage*, to capital account, and in the latter event will form part of the capital returnable through deductions for depletion."

REGULATIONS 45 (Preliminary edition, released February 25, 1919):

"ART. 201. [This was the same as in the permanent edition, quoted above]."

"ART. 203. [This was the same as in the permanent edition, quoted above, except that the word 'have' appeared in place of the word 'has' italicized, and the italicized words 'until the property reaches the operating stage' did not appear]."

REGULATIONS 45 (1920 edition, promulgated January 28, 1921):

"ART. 201. Depletion of mines, oil and gas wells; depreciation of improvements.—Sections 214 (a) (10) and 234 (a) (9) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. The provisions of the statute and these articles do not apply to or affect the regulations covering invested capital, losses, accounting methods, etc.

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions (see article 222), but not including land values for purposes other than the extraction of minerals.

"Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a stockholder in a mining or oil or gas corporation is not allowed such deductions. (See further articles 839 and 844.)

"When used in these *articles* of the regulations covering depletion and depreciation—

"(a) The term 'basic date' indicates the date of valuation, i.e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913,

or the date of discovery, or within 30 days thereafter, in the case of discovery.

"(b) The 'fair market value' of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase. Where there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date.

"(c) A 'mineral property' or 'property' is the oil or gas well, including the mineral, plant, development, and surface value of the land. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to 'minerals only,' such as the 'ores only' in the case of a mine, to the 'oil only' in the case of an oil well, and to the 'gas only' in the case of a gas well. The value of a mineral deposit is its cost; or it is the value of the mineral property, less the value of the plant, equipment, and surface of the land for purposes other than mineral production.

"(e) 'Minerals' comprise ores of the metals, coal, oil, gas, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand and gravel, silica, slate, soapstone, soda, sulphur, and talc.

"(f) 'Operating profit' is the net income from mineral production before depletion and depreciation are deducted. It is distinct from net income."

"ART. 203. Capital recoverable through depletion deductions in the case of lessee.—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

"(b) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

"(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

"(d) The value of a lessee's equity in a proven mineral property acquired *on or* after March 1, 1913, is its cost.

"(e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered."

The only differences between these articles as they appear in the 1920 edition and as they had been published in Treasury Decision 3107 (December 30, 1920, 22 Treasury Decisions 556), were the substitution of the word "articles" italicized in Art. 201 above, for "sections" in the Treasury Decision, and the insertion of the words "on or" italicized in Art. 203 (d) above, which did not appear in the Treasury Decision.

Corporation Excise Tax Act of 1909 (36 Stat. 113, 118, approved August 5, 1909:

"Chapter 7. Sec. 38 * * * (second) such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * *

"Second. * * * (second) all losses actually sustained within the year and not compensated by insurance or otherwise including a reasonable allowance for the depreciation of property, if any * * *."

REGULATIONS 31. (December 3, 1909):

"Article 4.—Deductions. * * *

"Depreciation.—The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the property, its cost value, and its use. Expenses paid in any one year in making good exhaustion, wear and tear, or obsolescence in respect of which any deduction for depreciation is claimed must not be included in the deduction for expense of maintenance and operation of the property or in the ascertainment of gross income, but must be made out of accumulative allowances deducted for depreciation in current and previous years."

TREASURY DECISION 1606 (approved March 29, 1910, 13 Treasury Decisions 39):

"Depreciation

"71. Where increase or decrease during the year in the value of real estate acquired in previous years, sold or held for sale, cannot be accurately determined, such increase or decrease may be prorated, as provided by regulations in cases of sale of capital assets.

"72. Depreciation in value of mines by the removal of ore, if not otherwise ascertainable, may be prorated as in the case of sales of capital assets.

"73. Depreciation in value of mines by the removal of ore, if in excess of 5 per cent of investment, to be explained in return rendered.

"74. Estimated depreciation in oil or gas wells, buildings, machinery, etc., to be stated in detail, if exceeding 5 per cent of value as previously inventoried.

"75. Corporations leasing mines and paying royalties on ore mined not entitled to deduction for depreciation. But corporations owning mines are entitled to allowances for depreciation based on fair estimate, etc.

"76. Removal of timber from timber lands, while depleting the lands to the extent of such removal, is regarded as a change in the form of assets and not a depreciation within the meaning of the act.

"77. Deduction on account of depreciation of property must be based on lifetime of property, its cost, value, and use.

"78. Voluntary removal of buildings, etc., for purpose of improvements not regarded as loss or depreciation, and no deduction therefor should be made.

"79. Depreciation of company's stock a loss to the stockholders, but not a loss to the company issuing the same, and therefore not a proper deduction."

TREASURY DECISION 1675 (February 11, 1911, 14 Treasury Decisions 16):

"The following synopsis of decisions made, from time to time, on questions relating to the special excise tax imposed by section 38, act of August 5, 1909, on corporations, joint-stock companies, associations, and insurance companies, is published for the information of internal-revenue officers and others concerned.

* * * * * * * *

"Depreciation.

* * * * * * * *

"72. Cost of drilling new wells by oil corporations is considered betterments and additions to the capital assets of the corporation. The expense of drilling dry wells may, however, be charged to profit and loss.

* * * * * * * *

"Depreciation in Minerals, Oils, Etc.

"80. In case of corporations whose business consists in part or wholly of mining, producing, and disposing of deposits of nature (ores, coals, gas, petroleum, and sundry minerals) the conduct of such business will be understood to comprehend two classes of gains or losses, viz:

"(a) The gain or loss resulting from the sale of capital assets, i.e., either the increment, or the loss, arising through possessing over a period of time the investment in the same.

"(b) The trading or commercial gain attached to the conduct of the industry, the employment of working capital, the effort and risk involved.

"81. In the ascertainment of net income deduction will be allowed for depreciation arising from exhaustion of deposits of ore, mineral, etc., and for depreciation and obsolescence of improvements, in accordance with general regulations respecting depreciation allowances, on the basis of the original capital investment cost of the properties concerned to the company reporting.

"82. A further deduction will also be allowed, through not including the same at all in the item of gross income (item 3, Form 637), for the unearned increment represented in such properties as at January 1, 1909, which will be determined in general as follows:

"83. An estimate should be made as of January 1, 1909, of the fair market value at that date of the minerals, etc., in deposit. This estimate should be formed on the basis of the disposal value of the minerals *in total* and exclusive of value of improvements and development work. This valuation should also be reduced to a unit value—per ton, barrel, etc.

"NOTE.—Values as aforesaid should not be estimated on the basis of the assumed salable value of the output under current operative conditions, less the actual cost of production, because, as hereinbefore stated, the selling price under such conditions comprehends a profit both for carrying the investment in minerals, improvements, and working capital, and for conducting operations in respect of production and disposal of product. The value to be determined as stated must be on the basis of the salable

value of the entire deposit of the aggregate units of minerals considered *en bloc* if disposed of in that form. Nor must such valuation comprehend any speculative value which might attach to a sale of the minerals *en bloc*, i.e., a value which might be obtained on the ground that the future would develop a much greater reserve of mineral deposits than were believed to exist at the time estimate as of January 1, 1909, was formed. Any value of this latter character would attach obviously to such additional reserves when developed in future.

"84. The unit value as of January 1, 1909, ascertained as above outlined, would indicate the value to be attached at that date to the capital assets disposed of during any calendar year succeeding, and should be used in determining the unearned increment at January 1, 1909, which may be excluded entirely from the item of gross income, as before explained, in following manner, viz:

Value at January 1, 1909, determined in manner outlined, of minerals, etc., which may be removed and disposed of in any year subsequent thereto.....		$———
Less the following:		
(a) Proportion of depreciation charge applying to exhaustion of minerals disposed of, ascertained as first explained herein on basis of original cost.....	$———	
(b) Royalty paid, if any, on minerals disposed of.....	———	———
Balance, being unearned increment at January 1, 1909, to be excluded from gross-income item.....		———

"85. The precise detailed manner in which the estimate of value of minerals, etc., as at January 1, 1909, shall be formed, must naturally be determined upon by each corporation interested, but formal record of such estimates, together with all sustaining information, should be carefully filed so as to be readily accessible for reference. Values as stated, as determined at January 1, 1909, should be used in compilation in all subsequent years' excise-tax returns. The question as to whether it subsequently develops the property possessed a greater quantity of mineral, etc., reserve than was in the aggregate estimated as of January 1, 1909, is immaterial. Any excess which may be developed will be considered as possessing the same value at January 1, 1909, as that which then may have been known to be in the property.

"86. Each excise-tax return (Form 637) should be accompanied with memorandum setting forth the extent in amount of the exclusion made from the item gross income for unearned increment realized during the year, as above outlined.

"87. As the amount to be deducted for depreciation (paragraph 2 preceding) is to be formed on basis of the estimated reserve of minerals, etc., it follows that if it develops such estimate is understated, the cost investment in the capital asset may be wholly extinguished before all mineral reserves are removed. When this is reached, further deductions for exhaustion of minerals should be discontinued but in such event, it will be noted, the allowance for unearned increment which is to be excluded entirely from gross income will be correspondingly increased.

"88. In case of corporations leasing mines and paying royalties on minerals, etc., removed, the

royalties paid are to be treated as expenses and deducted in ascertaining net income, as provided in general regulations. Any leasehold investment which the operating corporation may have in such properties, either through a payment originally made for acquirement thereof or for improvements made upon the property, to be accounted for in accordance with regulations governing depreciation allowances and disposition of capital assets.

"89. In respect to properties of the character in question which may be acquired by a corporation after January 1, 1909, a deduction will be allowed only as to depreciation arising from exhaustion based on original cost; no exclusion from gross income can be made for unearned increment, as profit arising in sale of such capital assets applies wholly to the period subsequent to January 1, 1909."

TREASURY DECISION 1755 (January 22, 1912, 15 Treasury Decisions 12):

"Item 80 of T. D. 1675 is hereby amended by striking out the parenthetical word 'petroleum,' and the following regulation to govern the rate of return of capital invested on the basis of the rate of depletion of oil-producing properties in making return of annual net income for the special excise tax on corporations is issued in lieu thereof:

"1. In the case of corporations whose business consists of producing and disposing of crude petroleum, the conduct of such business will be understood to comprehend two classes of gains or losses, viz: (a) The gain or loss resulting from the sale of capital assets—i. e., either the increment or the loss arising through possessing over a period of time the investment in the same. (b) The trading or commercial

gain attached to the conduct of the industry, the employment of working capital, and the effort and risk involved.

"2. In the ascertainment of net income, deduction will be allowed for depreciation arising from exhaustion of deposits and for depreciation and obsolescence of improvements in accordance with the general regulations respecting depreciation allowances, on the basis of the original capital-investment cost, reduced to a cash basis, of the properties concerned to the company reporting. Claims for depreciation on account of depletion of deposits based on any values other than the cost of the property in cash or cash values (including cost of development) will not be considered.

"3. In all producing oil fields an average value per barrel of the settled daily production shall be adopted as the guide in determining the value of the property, and the following method in depreciating said values is recommended:

"Each corporation will fix this valuation per barrel as of January 1, 1909, or upon the date of commencement of production, if after that date, for ascertaining the deductions for depreciation on the basis of depletion of deposits. This valuation per barrel should be based on the cost of the property to the corporation, plus the cost of the development thereof with a proper deduction from that valuation for the number of years the property has been in operation, and the resulting proportioned decrease in daily production of oil. With this basis per barrel fixed as of January 1, 1909, or at the date of commencement of production, if after January 1, 1909, the value of the property as a whole is to be determined by applying this unit value per barrel to the daily average production for the month

of December, or other representative month, in the year for which the return is made. The representative month chosen shall be the same in each year. This unit valuation per barrel is to be retained in arriving at all future depreciation deductions, except where an additional production is secured by drilling or an additional production is acquired by purchases, in which cases a new average rate per barrel based upon the actual cash invested in such development, or in the new properties and their development, may be adopted. The amount of income each year to be applied to the return of the cash investment shall be ascertained by multiplying the unit valuation ascertained as required above by the difference between the daily average production in barrels during the representative month of each year. The product of such multiplication will be the amount deductible from gross income on account of return of cash investment based upon the rate of depletion of deposits.

"4. The cost of drilling and equipping new producing wells shall be considered additions to capital investment account; the expense of drilling dry holes may be charged to profit and loss.

"5. The amount of petroleum produced and sold during the year or the price received for the same will not, so far as the application of this regulation to determine depreciation is concerned, affect the value of the property at the end of the year, which value is based only on the comparative rate of decrease in production in accordance with the standard unit value ascertained as stated above.

"6. Each excise tax return should be accompanied with a memorandum showing how the standard unit valuation was arrived at, i. e., the valuation of the producing property as of January 1, 1909, or at the

commencement of development, if after that date, and such additional investment in development as may have been made during the year, together with the daily average yield for each month of the year, or for each month since the commencement of operation, if subsequent to January 1, 1909.

"7. Where properties are operated upon lease, the cost of the leasehold interest, plus the cost of development, shall be the basis for determining the unit valuation for the purpose of providing for the deduction from gross income of the returnable cash investment.

"8. All depreciation deductions from the net income return must be evidenced by proper entries on the books of the corporation reporting, so as to show a reduction in the capital assets equal to the cash investment returned, as provided above, out of gross income.

"NOTE.—It will be apparent that by following the plan suggested, the value of the producing property appearing in the capital assets of the company will be automatically and wholly extinguished coincident with the complete exhaustion of the product, with the exception of such salvage as may remain after said exhaustion."

REVENUE ACT OF 1913 (approved October 3, 1913, 38 Stat. 166–81):

"SEC. 2. G. * * *

"(b) Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation

of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made; * * * ."

REGULATIONS 33 (approved January 5, 1914):

"ART. 130. The depreciation allowance, to be deductible, must be, as nearly as possible, the measure of the loss due to wear and tear, exhaustion, and obsolescence, and should be so entered on the books as to constitute a liability against the assets of the company, and must be reflected in the annual balance sheet of the company. The annual allowance deductible on this account should be such an amount as that the aggregate of the annual allowances deducted during the life of the property, with respect to which it is claimed, will not, when the property is worn out, exhausted, or obsolete, exceed its original cost.

"ART. 139. Corporations owning tracts of timber lands and removing therefrom and selling, or otherwise disposing of the timber will be permitted to deduct from their gross income on account of depreciation or depletion an amount representing the original cost of such timber, plus any carrying charges that may have been capitalized or not deducted from income. The purpose of the depreciation or depletion deduction is to secure to the corporation, when the timber has been exhausted, an aggregate amount

which, plus the salvage value of the land, will equal the capital actually invested in such timber and land.

"ART. 140. When an amount sufficient to return this capital has been secured through annual depreciation deductions no further deduction on this account shall be allowed. For the purpose of increasing the deduction on this account no arbitrary increase in values shall be made, unless such increase in value shall be returned as income for the year in which the increase in value was taken up on the books.

"ART. 141. The depreciation of coal, iron, oil, gas, and all other natural deposits must be based upon the actual cost of the properties containing such deposits. In no case shall the annual deduction on this account exceed 5 per cent of the gross value at the mine (well, etc.) of the output for the year for which the computation is made.

"ART. 142. The term 'gross value at the mine,' as used in paragraphs B and G of section 2 of the act of October 3, 1913, prescribing a limit to the amount which may be deducted in the return of individuals and corporations as depreciation in the case of mines, is held to mean the market value of ore, coal, crude oil, and gas at the mine or well, where such value is established by actual sales at the mine or well; and in case the market value of the product of the mine or well is established at some place other than at the mine or well, or on the basis of the bullion or metallic value of the ore, then the gross value at the mine is held to be the value of the ore, coal, oil, or gas sold, or of the metal produced, less transportation, reduction, and smelting charges.

"If the rate of 5 per cent per annum shall return to the corporation its capital investment prior to the ex-

haustion of the deposits, the rate on which the annual deduction for depletion of deposits is based must be lowered in accordance with the estimated number of years it will take to exhaust the estimated reserves.

"In case the reserves shall be in excess of the estimates, no further deduction on account of depletion shall be made where the capital investment has been returned to the corporation.

"ART. 143. In addition to the deduction to measure the loss due to depletion, the corporation will be allowed the usual depreciation of its machinery, equipment, etc., such depreciation to be determined on the basis of the cost and estimated life of the property with respect to which the depreciation is claimed.

"ART. 144. Corporations leasing oil or gas territory shall base their depletion deduction upon the cost of the lease, and not upon the estimated value, in place, of the oil or gas."

REVENUE ACT OF 1916 (approved September 8, 1916, 39 Stat. 756–77):

"SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

"(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * * * * *

"Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation

are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided*, That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. * * *"

"SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

* * * * * * * *

"Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (a) [balance indentical with Sec. 5 (a) Eighth, above]."

TREASURY DECISION 2447 (February 8, 1917, 19 Treasury Decisions 31):

"Section 5, deduction 'eighth,' and section 12, deduction 'second,' of Title I, act of September 8, 1916, authorize individuals and corporations owning and operating gas or oil producing properties to make deductions from gross income on account of depletion as follows:

"In the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production, to

be ascertained not by the flush flow but by the settled production or regular flow, provided that when the allowance authorized shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.

"The purpose of this provision is to afford a means whereby the individual or corporation owning oil or gas producing properties may, during the period of operation, deduct from gross income the cost of, or capital actually invested in, the natural deposits if the investment was made subsequent to March 1, 1913, or the fair market value as of March 1, 1913, if purchased prior to that date, the measure of the deduction being the reduction in the flow and production.

"The annual deduction authorized by the above-quoted provision must be reasonable and not in excess of such a percentage of the cost or value, as the case may be and as herein defined, of the oil or gas producing properties as is indicated by the reduction in the original flow or settled production of one year as compared with that of the preceding year.

"For the purpose of this deduction note may be taken of the reduction in flow and production of such individual wells as were producing oil or gas during or at some time within the year of groups of wells or of all wells in the field or territory embraced in the same ownership. If tested by the aggregate flow of all of the wells in the field or territory owned by an individual or corporation and new wells shall have been developed during the year, it is possible that at the end of the year there will have been no reduction in flow and production, in which case, under the specific provision of the law hereinbefore quoted and under which the depletion deduction is measured by the

reduction in flow and production, there can be no deduction for depletion.

"Hence, in the case of a field or territory in course of development or in which new wells are being drilled, if the depletion deduction is to be availed of in the returns of annual net income each individual well or possibly each group of wells in operation at the beginning of, or brought in, during the year, if the flow and production of the group of wells is so assembled as to be tested must be tested at the end of the year in order that the decline in the flow and production may be determined.

"New wells or new groups of wells brought in during the year may be tested as soon as they have reached the stage of settled production or regular flow, and then again at the end of the year. The decline in flow and production, if any, as indicated by these tests will be reduced to a percentage basis and a like percentage of the capital invested in the oil or gas property (exclusive of machinery, equipment, etc.) will constitute an allowable deduction from the gross income of the year on account of depletion. Thus, if the decline in the flow and production during the year of, say, 10 wells, costing $100,000, has been 5 per cent, as compared with the production and flow as indicated by a test made at the beginning of the period, then 5 per cent of $100,000, or $5,000, will, for the year for which the computation is made, constitute an allowable depletion deduction in favor of the individual or corporation owning and operating the property.

"If the wells are not so situated that their flow and production may be assembled in order to test and ascertain the reduction in the output as a basis for computing depletion, it will be necessary for the cor-

poration or individual owning the property and claiming a depletion deduction to take an accurate gauge of the production and flow of each well at a certain same period of each year, and by comparing this gauge with that of the previous year determine the percentage by which the production and flow has been reduced. This having been done as to all of the wells in operation, an average percentage rate of reduction in flow and production will be ascertained and this rate will be applied to the capital invested; that is, the value of the oil or gas property as of March 1, 1913, or the cost of the same if acquired subsequent to that date, for the purpose of determining the amount which may be allowably deducted from gross income by such owning individual or corporation on account of depletion.

"In case of a field or territory fully developed and in which no new wells are being drilled, a comparison of the quantity of oil or gas produced during the year for which the computation is made with the quantity produced during the last preceding year, will disclose the reduction, and the percentage thus indicated of the reduction in flow and production of such field will be the measure of the depletion deduction to be taken by the owner with respect to the capital invested in such field.

"Notwithstanding the fact that the drilling of new wells may offset the reduction in the production and flow of the older wells in the field not fully developed, the provision of the law hereinbefore quoted does not authorize, and this office can not permit, a depletion deduction to be taken so long as the flow and production of the unit, be it a well or group of wells or the entire territory, is as great during the year for which

the return is made as it was for the year immediately preceding.

"Illustrating in a general way the above rule as applied to a field or territory the case may be taken of an oil property in which the capital invested, either actual cost or fair market value, as the case may be, is $500,000 and the production during the year for which the return is made was 47,500 barrels, and for the year immediately preceding 50,000 barrels. This would indicate a reduction in production of 2,500 barrels, or a decline of 5 per cent. Applying this rate to the capital ($500,000) the individual or corporation owning the property would be entitled to deduct from gross income as depletion for the year for which the return is made the sum of $25,000, that is, 5 per cent of the invested capital.

"The depletion deduction in all cases until the capital invested is extinguished will be such a percentage of the unextinguished capital as the reduction in flow or production of one year is a percentage of the flow or production of the previous year.

"The estimate of the fair market value of gas and oil properties as of March 1, 1913, on which depletion deductions are based shall be the price at which the property as an entirety might have been sold for cash or its equivalent as of that date. The value hereinbefore contemplated must naturally be determined by each individual or corporation interested and who is the owner of the property upon such basis as will not comprehend any operating profits, the estimated value in all cases to be subject to the approval of the Commissioner of Internal Revenue.

"Every individual or corporation entitled to a deduction for depletion on account of reduction in flow

or production of oil or gas shall keep an accurate ledger account, in which shall be charged the fair market value as of March 1, 1913, or the cost, if the property was acquired subsequent to that date, of the property whose value declines with the removal of the natural deposits. This account shall be credited with the amount of the depletion deduction claimed and allowed each year, to the end that when the credits to the account equal the debits, no further deduction for depletion with respect to this property and the capital invested in it will be allowed.

"The value determined and set up as of March 1, 1913, or the cost of the property if acquired subsequent to that date, will be the basis for determining the depletion deduction for all subsequent years during the ownership under which the value was fixed, and during such ownership there can be no revaluation for the purpose of this deduction if it should be found that the estimated quantity of oil or gas contained in the property was understated at the time the value was fixed or at the time the property was acquired.

"The provision of the law authorizing the depletion deduction, designed as it is to provide a means whereby the invested capital of an individual or corporation may not be subject to the tax imposed by this title, does not apply to individuals or corporations who are operating oil or gas properties under lease, since in those cases the operator has no capital invested in such properties. By capital invested, as herein used, is meant the fair market value of the properties as of March 1, 1913, if acquired prior to that date, or their actual cost if acquired subsequent to that date, as it relates to the owner in fee of the properties.

"Lessees will, however, be permitted to deduct from gross income each year a reasonable allowance for depreciation, which depreciation applies to the physical property, including rigs, tools, machinery of all kinds, pipes, casing, and other equipment necessary to the operation of the wells or field. If lessees, in order to secure the right to enter upon, explore, develop, or operate gas or oil properties, paid or shall pay a bonus in addition to royalties the amount of such bonus so paid may be ratably distributed over the life of the lease or over the productive life of the property, and the lessee may deduct annually as a rental payment an aliquot part of the amount of the bonus so paid until such amount has been extinguished.

"The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense. If, in exercising the option, the operating individual or company charges the expense of drilling wells to property account, the same may be taken into account in determining a reasonable allowance for depreciation during each year until the property account thus augmented has been extinguished through annual depreciation deductions, after which no further deduction on this account will be permitted. The cost of drilling dry or nonproductive wells may be deducted from gross income as a loss.

"To each return made by an individual or corporation owning and operating oil or gas properties there

should be attached a statement showing (1) (a) the fair market value of the property (exclusive of machinery, equipment, etc.) as of March 1, 1913, if acquired prior to that date, or (b) the actual cost of the property if acquired subsequent to that date; (2) how the fair market value of the property as of March 1, 1913, was ascertained; (3) the quantity of oil or gas produced during the year for which the return was made; (4) the quantity produced during the year immediately preceding; (5) how the depletion deduction claimed in the return was computed, whether upon the decline in flow and production of individual wells, groups of wells, or the entire field; and (6) any other data which would be helpful in determining the reasonableness of the depletion deduction claimed in the return.

"If the operator is a lessee that fact should be stated and an explanation given as to the basis and property upon which any depreciation deduction is claimed, it being understood, as hereinbefore indicated, that depreciation relates to the loss due to the use, wear, and tear of physical property, and that the lessee is not entitled to any deduction for the depletion or exhaustion of the oil or gas deposits, but may deduct annually as a rental payment an aliquot part of any bonus paid for the right to enter upon, explore, develop, and operate oil or gas territory, as well as the royalty payments made to the lessor for the oil or gas removed from such property, provided the entire proceeds from the oil or gas produced during the year are returned in the gross income of the operator.

"The above rule for computing allowable depletion deductions being set out in the law, no deduction on this account will be allowed if computed upon any

basis other than that authorized by the law and further amplified in this decision."

REGULATIONS 33, REVISED (approved October 3, 1917):

"ART. 170. Sections 5 and 12 of the act of September 8, 1916, as amended by the act of October 3, 1917, authorize individuals and corporations owning and operating gas or oil properties, to deduct from gross income—

"'A reasonable allowance * * * for actual reduction in flow and production, * * * provided that when the allowance authorized * * * shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.'

"The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date.

"For the purpose of determining the amount of capital to be returned through annual deductions, operators may be divided into two classes, (a) operators who own the fee, and (b) operators who own a lease or leases.

"In the case of the operating fee owner, the amount returnable through depletion deductions is the fair market value of the property (exclusive of the cost of physical property) as of March 1, 1913, if acquired prior to that date, or the actual cost of the property if acquired subsequent to that date, plus, in either

case, the cost of development (other than the cost of physical property incident to such development) up to the point at which the income from the developed territory equals or exceeds the deductible expenses.

"In the case of a lessee, the capital thus to be returned is the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease, plus also all expenses incurred in developing the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible expenses, after which time as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account.

"If, in exercising this option, the individual or corporation charges the expense of drilling wells or further development to capital account, the same, in so far as such expense is represented by physical property, may be taken into account in determining a reasonable allowance for depreciation during each year until the property account thus augmented has been extinguished through annual depreciation deductions, after which no further deduction on this account will be allowed. In the case of a going or producing business, the cost of drilling nonproductive wells may be deducted from gross income as an operating expense.

"ESTIMATE OF PROBABLE RESOURCES.

"In the case of either an owner or lessee it will be required that an estimate, subject to the approval of the Commissioner of Internal Revenue, shall be made

of the probable quantity of oil or gas contained in or to be recovered from the territory with respect to which the investment is made. The invested capital (value as of Mar. 1, 1913, or cost, if acquired subsequent to that date, plus the cost of development, other than cost of physical property, up to the point of expense-paying production, in the case of an owner, and the amount actually paid for the lease plus cost of development, other than cost of physical property, up to the same point, in the case of a lessee) will be divided by the number of units of oil or gas so estimated to be contained in or to be recovered from the territory, and the quotient will be the per unit cost or amount of capital invested in each unit recoverable. This quotient, or per unit cost, when multiplied by the number of units removed from the territory during any one year, will determine the amount which may be allowably deducted from the gross income of that year on account of depletion of assets or as a return of invested capital until the total of such deductions shall equal the capital invested.

"Every individual or corporation entitled to a deduction on account of the depletion of the property under operation or for a return of the capital invested with respect to the same shall keep an accurate ledger account, in which, in the case of fee owner, shall be charged the fair market value as of March 1, 1913, or the cost, if acquired subsequent to that date, of the oil or gas property, plus cost of development as hereinbefore defined, or, in the case of a lessee, the amount actually originally invested in the case and its development. This account shall be credited with the amount claimed and allowed each year as a deduction on account of depletion or as a return of capital, to the end that when the credits to the account equal

the debits no further deduction on either account, with respect to this property and the capital invested therein, will be allowed. Or, in lieu of a direct credit to property account, the amount so claimed and allowed as a deduction may be credited to a depletion reserve account.

"WHERE RESOURCES ARE UNCERTAIN.

"If for any reason the quantity of oil or gas in the property can not be determined with any degree of certainty, the depletion deduction will be computed in accordance with the rule set out in Treasury Decision 2447, except that lessees may compute their deduction for return of capital (cost of lease and development) in the same manner as owners in fee; that is, they may extinguish such capital on the basis of the reduction in flow and production as compared with the preceding year, or, in the case of leasehold properties brought in or developed during the year, the depletion deduction may be computed on the basis of the decline in settled flow and production, as evidenced by tests and gauges made at the end of the year as compared with similar tests and gauges made at the time the settled flow was determined.

"For the purpose of computing the depletion the territory comprehended in a given lease will be considered the unit with respect to which the depletion deduction may be claimed and allowed.

"If the operator is the owner of the fee the value determined and set up as of March 1, 1913, or the cost of the property if acquired subsequent to that date, or, if the operator is a lessee, the amount actually paid for the lease, plus, in the case of both owner and lessee, the cost of subsequent development, exclusive of physical property, if such cost is

capitalized, will be the basis for determining the depletion deduction or the deduction for return of capital for all subsequent years during the continuance of the ownership under which the value was fixed or by which the investment was made, and during such ownership there can be no revaluation for the purpose of this deduction if it should be found that the quantity of oil or gas in the property was underestimated at the time the value was fixed or the property was acquired, or at the time the lease contract was entered into or purchased.

"This rule will not, however, be so construed as to forbid an operator from redistributing the invested capital over the estimated number of units remaining in the territory under operation if a subsequent increase of invested capital should render this necessary in order to determine the amount of such capital applicable to each unit, provided that when such redistribution is made the total capital invested will be reduced by the amount previously charged off and deducted on account of depletion or as a return of capital."

REVENUE ACT OF 1924 (approved June 2, 1924):

"SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

"(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or deple-

tion, previously allowed with respect to such property."

"SEC. 204. * * * * * * * * * * *

"(b) The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property (or, in the case of such property as is described in paragraph (1), (4), or (5), of subdivision (a), the basis as therein provided), or (B) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

"(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except [the exceptions deals with discovery subsequent to February 28, 1913]."

REVENUE ACT OF 1926 (approved February 26, 1926):

"SEC. 202. (a) [Identical with Sec. 202 (a) of the Revenue Act of 1924, above].

"(b) In computing the amount of gain or loss under subdivision (a)—

"(1) Proper adjustment shall be made for any expenditure or item of loss properly chargeable to capital account, and

"(2) The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, ob-

solescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws; but in no case shall the amount of the diminution in respect of depletion exceed a depletion deduction computed without reference to discovery value or to paragraph (2) of subdivision (c) of section 204. In addition, if the property was acquired before March 1, 1913, the basis (if other than the fair market value as of March 1, 1913) shall be diminished in the amount of exhaustion, wear and tear, obsolescence, and depletion actually sustained before such date.

"SEC. 204. * * * *

"(b) [Identical with Sec. 204 (b) of the Revenue Act of 1924, above]."

"(c) [Identical with Sec. 204 (c) of the Revenue Act of 1924, as far as quoted above but makes additional provisions for discovery values and for depletion allowance based on 27½% of gross income]."

REVENUE ACT OF 1928 (approved May 29, 1928):

"SEC. 111. (a) [Identical with Sec. 202 (a) of the Revenue Act of 1924, above].

"(b) [Identical with Sec. 202 (b) of the Revenue Act of 1926, above, except for a cross reference to percentage depletion not found in the 1926 Act]."

"SEC. 113. * * *

"(b) [Identical with Sec. 204 (b) of the Revenue Act of 1924, above, except for use of numbers instead of letters to indicate categories, and reference to 'subdivisions' instead of to 'paragraphs'.

"SEC. 114. * * *

"(b) Basis for depletion.—

(1) General rule.—The basis upon which depletion is to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property, except as provided in paragraphs (2) and (3) of this subsection."